RETURN ON EQUITY RATIO(ROE)

1. What is Return on Equity (ROE)?

Return on Equity (ROE) is a profitability ratio that shows how well a company uses the money from its owners to make profits.

It expresses how much profit is made for every dollar of shareholder investment.

2. How do you calculate the return on equity?

$$\text{Return on Equity(ROE)} = \frac{\text{Net Income after Taxes}}{\text{Shareholders' Equity}} * 100$$

EXAMPLE

A company earns 80.000€ is net profit and its shareholders' equity is 500.000 €. Shareholders' equity includes things like common shares, preferred shares, retained earnings and any capital contributed. More specifically:

- Common shares: 250.000 €
- Preferred shares: 150.000€
- Retained earnings: 100.000€

So,

Total shareholders' equity is

250.000 €+150.000€+100.000€=500.000€

$$\boldsymbol{Return\ on\ Equity(ROE)} = \frac{80.000€}{500.000\ €} * 100 = \mathbf{16\%}$$

3. How does it mean?

This company earns 0.16€ for every 1 € that shareholders have invested. A 16% ROE is generally considered strong, especially if it's consistent over time or better than similar companies.

4. Understanding Return on Equity?

Calculating your company's ROE helps you understand its financial performance and how effectively it uses shareholder's money to generate profit.

ROE is commonly used in two types of analysis:

- **Time Analysis**: Track how your company's ROE changes over time.

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- **Competitive Analysis**: Compare your company's ROE WITH other similar companies in your industry.

5. What is considered a "Good "ROE"?

A "Good" ROE can very depend on the industry, but 15% to 20% is usually considered strong. On the other hand, 5% ROE is seen as low

6. How to Calculate and Interpret ROE when Equity is negative?

Sometimes, a company return on equity (ROE) can give misleading results, especially if the shareholders' equity is negative. Since ROE is calculated by dividing earnings after tax by equity, a negative equity value can distort the results.

When both net incomes are negative, the ROE might appear positive, but that doesn't mean the company is doing well.

In such cases, you need to reserve your interpretation. A lower ROE (even negative) could indicate better performance than a misleadingly high ROE with negative equity.

EXAMPLE

A company has

- Shareholders' equity: -500.000 €
- Earnings after tax: -50.000 €

The ROE would be:

$$\textbf{Return on Equity(ROE)} = \frac{-50.000€}{-500.000\,€} * 100 = \textbf{10\%}$$

At first glance, this 10% ROE might look good. But since both numbers are negative, it can give a false impression of profitability.

A company with positive equity and lower ROE may be in a stable position.

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